

Internal Revenue Service

Number: **201313012**
Release Date: 3/29/2013
Index Number: 168.36-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

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Refer Reply To:
CC:ITA:7
PLR-128566-12
Date:
December 28, 2012

Re: Request for Private Letter Ruling under Section 168(k)

Legend

Taxpayer =
State1 =
City1 =
Facility =
Contract =
A =

B =
C =
D =
E =
F =
Number1 =
Number2 =
Number3 =
Number4 =
Number5 =
Number6 =
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Year1 =
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Date1 =
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Date11 =

Dear :

This letter responds to a letter dated July 3, 2012, submitted by A on behalf of Taxpayer, requesting rulings under section 168(k) of the Internal Revenue Code.

FACTS

Taxpayer represents that the facts are as follows:

A is a corporation organized and incorporated under the laws of State1. A is an energy services company operating two primary businesses: Taxpayer, an electric utility, and B, a wholesale energy business.

Taxpayer is a limited liability company that is directly owned by A. Taxpayer is treated as a corporation for Federal income tax purposes and joins in the consolidated federal income tax return filed for the affiliated group headed by A. A files its consolidated federal income tax return on a calendar year basis. A and Taxpayer use the accrual method of accounting. Taxpayer represents that its method of accounting for economic performance for purposes of section 461 for property provided to the taxpayer is acceptance.

Taxpayer owns electric utility operations and assets, including distribution and transmission lines and regulated generation facilities. Taxpayer is regulated by the C and D. As a regulated utility, Taxpayer provides electric utility services to commercial and residential customers throughout central State1.

In Year1, Taxpayer initiated a plan to acquire a solid fuel generation plant. Taxpayer and E entered into a Contract for the Facility on Date1.

Taxpayer represents that the Contract is a binding contract under the law of State1, which is the governing law under the Contract. Further, Taxpayer represents that the Contract did not limit damages to an amount that is less than five percent of the Contract price.

The Contract is a lump sum turnkey contract. Under the Contract, E was to construct a new Number1 megawatt power plant at an existing power facility near City1, State1. The Facility was designed to use two Number2 megawatt circulating fluidized-bed steam boilers to provide steam for its turbine generator. The primary fuel for the boilers is petroleum coke, or "pet coke", a by-product of the crude oil refining process.

Taxpayer assumed full responsibility and liability for payment under the Contract. Pursuant to the Contract, Taxpayer could terminate the Contract at any time without liability for damages and without need to show cause by giving 10 days notice to E. Upon termination, Taxpayer must compensate E for all payment events completed up to the date of termination and that had not previously been paid to E and an amount mutually agreed to for the completed percentage of partially completed payment events, costs incurred by E to demobilize the Facility site, and costs incurred by E in terminating contracts with subcontractors.

The Contract price was the lump sum turnkey price of initially \$Number3. Pursuant to Article XXIII of the Contract, throughout the construction of the Facility, payments were made by Taxpayer to E according to a payment schedule based on payment events.

The Contract was subject to a number of amendments and a change order. These amendments and change order increased the initial Contract price for the Facility by \$Number4 to a total amended price of \$Number5. The fourth amendment revised the range of elements required in the composition of the pet coke with corresponding amendments to the performance, emission, and boiler and auxiliary equipment guarantees. Specifically, the guaranteed output of the Facility was reduced from Number1 megawatts to Number6 megawatts, and the guaranteed heat rate was raised from Number7 British thermal units per kilowatt hour to Number8 British thermal units per kilowatt hour. None of the amendments or the change order to the Contract changed the location of the Facility or the nominal nameplate capacity of the Facility.

Further, on Date2, E initiated an arbitration proceeding against Taxpayer, seeking payment of the contract balance, a time extension, and damages for delay, lost productivity, and extra work in relation to the Contract of the Facility. On Date3, the arbitrator announced a decision in favor of E. Separate from the arbitration proceedings, Taxpayer had claims against E, seeking payment for damages related to reliability testing deficiencies regarding the construction of the Facility as well as some expenditures incurred by Taxpayer related to repairs that Taxpayer claimed under the warranty agreement. Effective Date4, Taxpayer and E entered into an agreement ("Settlement Agreement") that settled all claims regarding the Facility (excluding claims in the arbitration proceedings). As a result of the payments under the arbitration proceedings, the Settlement Agreement, and the amendments and change order to the Contract mentioned in the prior paragraph, the final Contract price for the Facility is \$Number9.

Under Article XXIV of the Contract, E assumed the risk of loss for the Facility through Substantial Completion and Taxpayer assumed the risk of loss for the Facility upon Substantial Completion.

Article I of the Contract states that Substantial Completion has the meaning set forth in Article XXII. Article 22.1 of the Contract defines Substantial Completion as follows:

For purposes of Section 16.5 (Warranty Remedy Periods) and Section 23.1 (Delay Liquidated Damages), the date Substantial Completion is achieved shall be the date of achievement of (a) simultaneous Provisional Net Heat Rate Level, Provisional Net Unit Capacity Level, the Emission Guarantees and the Noise Level Guarantee in accordance with Exhibit I, and (b) the Provisional Reliability Level. For all other purposes under this Contract, the date of Substantial Completion shall be the date [Taxpayer] issues the Substantial Completion certificate evidencing [Taxpayer's] agreement that Substantial Completion has been achieved, which [Taxpayer] shall use commercially reasonable efforts to issue promptly after the requirements thereof have been met.

Article 22.1 of the Contract further specifies that upon Substantial Completion, Taxpayer shall assume operational control of the Facility.

In Date5, construction commenced at the site. Substantial Completion of the Facility occurred on Date6. Taxpayer represents that the Facility was originally placed in service on Date6, and that Taxpayer is the original user of the Facility. On Date7, the Facility was renamed E.

In addition to the payments made by Taxpayer to E for the Facility, Taxpayer incurred interest expenditures for the Facility and other costs for the Facility for items such as permitting, project development, project design, engineering, preconstruction, and construction management. Taxpayer further represents that with respect to the Facility, assuming that no costs were incurred with respect to the Contract until Substantial Completion, the costs that were incurred as of January , 20 , including capitalized interest accrued, were percent or less of the total cost of the Facility (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching).

Taxpayer represents that the Facility is described in asset class 49.13 of Rev. Proc. 87-56, 1987-2 C.B. 674, or in asset class 49.14 of Rev. Proc. 87-56.

The Facility was, in part, financed by tax-exempt bonds. The assets financed by the tax-exempt bonds are required to be depreciated under the alternative depreciation system of section 168(g) (ADS) and are not part of this letter ruling request. No portion

of the property subject to this letter ruling request is required to be depreciated under the ADS. Further, the property subject to this letter ruling request does not include land, buildings, or other section 1250 property. Any costs incurred by Taxpayer prior to January , 20 , are not subject to this letter ruling request.

Taxpayer did not claim the additional first year depreciation under section 168(k) for the Facility for the Year2 taxable year. Taxpayer also did not make an election not to deduct the additional first year depreciation under section 168(k) for any class of qualified property placed in service by Taxpayer during Year2.

Completed transaction in a year for which the return has been filed

Taxpayer represents that it placed the Facility in service on Date6, which is during Year2. A filed its consolidated federal income tax return for its Year2 taxable year before Taxpayer submitted this letter ruling request. Section 5.01 of Rev. Proc. 2012-1, 2012-1 I.R.B. 1, provides that an Associate office (as defined in section 1.01(2) of Rev. Proc. 2012-1) will not ordinarily issue a letter ruling on a completed transaction if the letter ruling request is submitted after the return is filed for the year in which the transaction is completed. Section 5.01 of Rev. Proc. 2012-1 defines "not ordinarily" as meaning that unique and compelling reasons must be demonstrated to justify the issuance of a letter ruling submitted after the return is filed for the year in which the transaction is completed. Moreover, the taxpayer must contact the Field office (as defined in section 1.01(4) of Rev. Proc. 2012-1) having audit jurisdiction over the taxpayer's return and obtain the Field's consent to the issuance of such a letter ruling.

On Date8, Taxpayer obtained consent from a LB&I Team Manager to the issuance of the letter ruling. Moreover, Taxpayer provided a letter dated Date9, from the Secretary, C, requiring Taxpayer to request a letter ruling regarding the Facility's eligibility for additional first year depreciation deduction under section 168(k). Accordingly, we conclude that Taxpayer has demonstrated unique and compelling reasons to justify the issuance of this letter ruling.

Form 3115, Application for Change in Accounting Method

In accordance with section 7.04(1) of Rev. Proc. 2012-1, Taxpayer notified this office that it filed a Form 3115, Application for Change in Accounting Method, under Rev. Proc. 2011-14, 2011-1 C.B. 330, to change from not claiming the additional first year depreciation deduction under section 168(k) to claiming the additional first year depreciation deduction under section 168(k) for the section 1245 property that is located at the Facility and placed in service in Year2, for its taxable year ending Date10 (the Year3 taxable year). Taxpayer filed this Form 3115 in Date11, while Taxpayer's letter ruling request was pending with this office. Taxpayer submitted a copy of the Form 3115 to this office.

RULINGS REQUESTED

1. The Contract is a written binding contract within the meaning of section 1.168(k)-1(b)(4)(ii) of the Income Tax Regulations.
2. The Facility is self-constructed property as defined in section 1.168(k)-1(b)(4)(iii)(A).
3. The fact that Taxpayer and E entered into the Contract prior to January 1, 2008, does not prevent the Facility from meeting the acquisition requirements in section 168(k)(2)(A)(iii).
4. For purposes of determining when physical work of a significant nature begins under the safe harbor under section 1.168(k)-1(b)(4)(iii)(B)(2), no costs are incurred by Taxpayer under the Contract until Substantial Completion (as defined in the Contract) has occurred. As a result, no costs attributable to the Contract were incurred until Date6.
5. For purposes of section 1.168(k)-1(b)(4)(iii)(B)(2), construction of the Facility began after December 31, 2007.
6. The section 1245 property at the Facility qualifies for the 50-percent additional first year depreciation deduction under section 168(k)(1).
7. Taxpayer may change from not claiming to claiming the additional first year depreciation deduction provided by section 168(k) for the Facility by filing a request for an automatic change in its method of accounting for the Year3 taxable year.

LAW AND ANALYSIS

Section 168(k)(1)(A) (as amended by the Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat. 613 (February 13, 2008) ("Stimulus Act")) provides a 50-percent additional first year depreciation deduction for the taxable year in which qualified property is placed in service by a taxpayer.

Section 168(k)(2)(A) (as amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (December 17, 2010) ("TRUIRJCA")) defines the term "qualified property" as meaning property (i) among other things, to which section 168 applies with a recovery period of 20 years or less, (ii) the original use of which commences with the taxpayer after December 31, 2007, (iii) that is acquired by the taxpayer after December 31, 2007, and before January 1, 2013, but only if no written binding contract for the acquisition was in effect before January 1, 2008, or that is acquired by the taxpayer pursuant to a written

binding contract which was entered into after December 31, 2007, and before January 1, 2013, and (iv) that is placed in service by the taxpayer before January 1, 2013, or in the case of property described in section 168(k)(2)(B) or (C), before January 1, 2014.

For purposes of section 168(k)(2)(A)(i), section 1.168(k)-1(b)(2)(i)(A) provides that the recovery period is determined in accordance with section 168(c) regardless of any election made by the taxpayer under section 168(g)(7). The recovery period under section 168(c) is determined by the property's classification under section 168(e).

For purposes of section 168(e), a property's classification is determined by reference to the property's class life or by statute. Section 168(e)(1) provides that property with a class life of 25 or more years is 20-year property.

Section 168(i)(1) defines the term "class life" as meaning the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under section 167(m) (determined without regard to section 167(m)(4) and as if the taxpayer had made an election under section 167(m)) as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990. Former section 167(m) provided that in the case of a taxpayer who elected the Class Life Asset Depreciation Range system of depreciation, the depreciation allowance was based on the class life prescribed by the Secretary that reasonably reflected the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) provides rules for classifying property under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the activity in which the property is primarily used is insubstantial in relation to all the taxpayer's activities.

Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowance under section 168. This revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific depreciable assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of depreciable assets used in specific business activities. An asset that falls within both an asset group (that is, asset classes 00.11 through 00.4) and an activity group (that is, asset classes 01.1 through 80.0) would be classified in the asset group. See *Norwest Corp. & Subs. v. Commissioner*, 111 T.C. 105, 156-64 (1998). The asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 49.13, Electric Utility Steam Production Plant, of Rev. Proc. 87-56, includes assets used in the steam power production of electricity for sale, combustion turbines operated in a combined cycle with a conventional steam unit and related land improvements. Asset class 49.13 also includes package boilers, electric generators

and related assets such as electricity and steam distribution systems as used by a waste reduction and resource recovery plant if the steam or electricity is normally for sale to others. Assets in class 49.13 have a class life of 28 years and, in accordance with section 168(e)(1), are classified as 20-year property. Pursuant to section 168(c), the recovery period for 20-year property is 20 years.

Asset class 49.14, Electric Utility Transmission and Distribution Plant, of Rev. Proc. 87-56, includes assets used in the transmission and distribution of electricity for sale and related land improvements. Asset class 49.14 excludes initial clearing and grading land improvements as specified in Rev. Rul. 72-403, 1972-2 C.B. 102. Assets in class 49.14 have a class life of 30 years and, in accordance with section 168(e)(1), are classified as 20-year property. Pursuant to section 168(c), the recovery period for 20-year property is 20 years.

Section 168(k)(2)(E)(i) (as amended by the TRUIRJCA) provides that in the case of a taxpayer manufacturing, constructing, or producing property for the taxpayer's own use, the requirements of section 168(k)(2)(A)(iii) shall be treated as met if the taxpayer begins manufacturing, constructing, or producing the property after December 31, 2007, and before January 1, 2013.

With the exception of the increased amount and the revised dates, the rules for determining whether depreciable property is eligible for the 50-percent additional first year depreciation deduction are the same as the rules in section 168(k) in effect before the enactment of the Stimulus Act. Accordingly, rules similar to the rules in section 1.168(k)-1 for "qualified property" or for "30-percent additional first year depreciation deduction" apply. See section 5.01 of Rev. Proc. 2008-54, 2008-2 C.B. 722.

Section 1.168(k)-1(b)(4)(i) provides the rules relating to section 168(k)(2)(A)(iii) [the acquisition requirement] and section 1.168(k)-1(b)(4)(iii) provides the rules relating to section 168(k)(2)(E)(i) [self-constructed property].

For purposes of the 50-percent additional first year depreciation deduction, section 1.168(k)-1(b)(4)(i) provides that depreciable property will meet the requirements of section 1.168(k)-1(b)(4) if the property is: (1) acquired by the taxpayer after [December 31, 2007], and before [September 9, 2010], or acquired generally after [December 31, 2011], and before [January 1, 2013], but only if no written binding contract for the acquisition of the property was in effect before [January 1, 2008]; or (2) acquired by the taxpayer pursuant to a written binding contract that was entered into after [December 31, 2007], and before [January 1, 2013].

Section 1.168(k)-1(b)(4)(ii) defines a binding contract. Section 1.168(k)-1(b)(4)(ii)(A) provides that a contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). For this purpose, a

contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account. For example, if a taxpayer entered into an irrevocable written contract to purchase an asset for \$100 and the contract contained no provision for liquidated damages, the contract is considered binding notwithstanding the fact that the asset had a fair market value of \$99 and under local law the seller would only recover the difference in the event the purchaser failed to perform. If the contract provided for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation, the contract is not considered binding.

Section 1.168(k)-1(b)(4)(ii)(B) provides that a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions or because any term is to be determined by a standard beyond the control of either party. A contract that imposes significant obligations on the taxpayer or a predecessor will be treated as binding notwithstanding the fact that certain terms remain to be negotiated by the parties to the contract.

Section 1.168(k)-1(b)(4)(iii)(A) provides that if a taxpayer manufactures, constructs, or produces property for use by the taxpayer in its trade or business (or for its production of income), the acquisition rules in section 1.168(k)-1(b)(4)(i) are treated as met for qualified property if the taxpayer begins manufacturing, constructing, or producing the property after [December 31, 2007], and before [January 1, 2013]. This regulation further provides that property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract (as defined in section 1.168(k)-1(b)(4)(ii)) that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business (or for its production of income) is considered to be manufactured, constructed, or produced by the taxpayer.

Section 1.168(k)-1(b)(4)(iii)(B)(1) provides that for purposes of section 1.168(k)-1(b)(4)(iii), manufacture, construction, or production of property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances.

Section 1.168(k)-1(b)(4)(iii)(B)(2) provides that for purposes of section 1.168(k)-1(b)(4)(iii)(B)(1), a taxpayer may choose to determine when physical work of a significant nature begins in accordance with the safe harbor rule provided in section 1.168(k)-1(b)(4)(iii)(B)(2). Under this safe harbor rule, physical work of a significant nature will not be considered to begin before the taxpayer incurs (in the case of an

accrual basis taxpayer) or pays (in the case of a cash basis taxpayer) more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching). When property is manufactured, constructed, or produced for the taxpayer by another person, this safe harbor rule must be satisfied by the taxpayer. A taxpayer chooses to apply section 1.168(k)-1(b)(4)(iii)(B)(2) by filing an income tax return for the placed-in-service year of the property that determines when physical work of a significant nature begins consistent with section 1.168(k)-1(b)(4)(iii)(B)(2).

Section 1.168(k)-1(b)(4)(iii)(C) provides the rules relating to components of self-constructed property. If such component is acquired by the taxpayer, the rules in section 1.168(k)-1(b)(4)(iii)(C)(1) apply to the acquired component. If the component is self-constructed, the rules in section 1.168(k)-1(b)(4)(iii)(C)(2) apply to the self-constructed component.

Section 1.168(k)-1(b)(4)(iii)(C)(1) provides that if a binding contract (as defined in section 1.168(k)-1(b)(4)(ii)) to acquire a component does not satisfy the requirements of section 1.168(k)-1(b)(4)(i), the component does not qualify for the 50-percent additional first year depreciation deduction. A binding contract to acquire one or more components of a larger self-constructed property will not preclude the larger self-constructed property from satisfying the acquisition rules in section 1.168(k)-1(b)(4)(iii)(A). Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the 50-percent additional first year depreciation deduction must not include the unadjusted depreciable basis of any component that does not satisfy the requirements of section 1.168(k)-1(b)(4)(i). If the manufacture, construction, or production of the larger self-constructed property begins before [January 1, 2008], the larger self-constructed property and any acquired components related to the larger self-constructed property do not qualify for the 50-percent additional first year depreciation deduction.

Section 1.168(k)-1(b)(4)(iii)(C)(2) provides that if the manufacture, construction, or production of a component does not satisfy the requirements of section 1.168(k)-1(b)(4)(iii)(A), the component does not qualify for the 50-percent additional first year depreciation deduction. However, if the manufacture, construction, or production of component does not satisfy the requirements of section 1.168(k)-1(b)(4)(iii)(A), but the manufacture, construction, or production of the larger self-constructed property satisfies the requirements of section 1.168(k)-1(b)(4)(iii)(A), the larger self-constructed property qualifies for the 50-percent additional first year depreciation deduction (assuming all other requirements in section 168(k)(2) are met). Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the 50-percent additional first year depreciation deduction must not include the unadjusted depreciable basis of any component that does not qualify for the 50-percent additional first year depreciation deduction. If the manufacture, construction, or production of the larger self-constructed property began before [January 1, 2008], the larger self-

constructed property and any self-constructed components related to the larger self-constructed property do not qualify for the 50-percent additional first year depreciation deduction.

Section 461(a) provides, in part, that a deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) provides, in part, that under an accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h) provides, in part, that in determining whether an amount has been incurred with respect to any item during the taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item has occurred.

Section 461(h)(2)(A)(i) and (ii) provide that if the liability of the taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as services or property is provided. Section 461(h)(2)(D) provides that in the case of any other liability not specifically mentioned in section 461(h), economic performance occurs at the time determined by the Internal Revenue Service in regulations.

Section 1.461-4(g) provides a list of specifically enumerated items for which economic performance is satisfied by payment. Section 1.461-4(g)(7) provides that in the case of a taxpayer's liability for which economic performance rules are not otherwise provided elsewhere in the Code or other rules, economic performance occurs as the taxpayer makes payments in satisfaction of the liability. Section 1.461-4(g)(7) further states that its only application is if the liability in question is not covered by rules provided elsewhere under section 461.

Section 1.461-4(d)(2)(i) provides that if the liability of a taxpayer arises out of providing services or property to the taxpayer by another person, economic performance occurs as services or property is provided.

Section 1.461-4(d)(6)(iii) provides that a taxpayer is permitted to treat property as provided to the taxpayer when the property is delivered or accepted, or when title to the property passes.

Section 1.461-4(e) provides that in the case of interest, economic performance occurs as the interest cost economically accrues, in accordance with the principles of relevant provisions of the Code.

Section 263A(a)(1) provides that in the case of any property to which section 263A applies, the direct costs of the property and the indirect costs properly allocable to the property shall be included in inventory costs (in the case of property that is inventory in the hands of the taxpayer) or shall be capitalized (in the case of other property).

Section 263A(b)(1) provides that, except as otherwise provided, section 263A shall apply to real or tangible personal property produced by the taxpayer. See *also* section 1.263A-1(a)(3)(i). For purposes of section 263A, section 263A(g)(1) provides that the term "produce" includes construct, build, install, manufacture, develop, or improve. See *also* section 1.263A-2(a)(1).

Section 263A(f)(1) provides that interest costs for property produced by the taxpayer is capitalized in case of interest costs which are paid or incurred during the production period, and allocable to property described in section 263A(b)(1) and which has a (i) long useful life, (ii) an estimated production period exceeding 2 years, or (iii) an estimated production period exceeding 1 year and a cost exceeding \$1,000,000.

Section 263A(f)(4)(A) provides that property has a long useful life if such property is real property, or property with a class life of 20 years or more under section 168.

Section 263A(f)(4)(B) provides that the term "production period" means, when used with respect to any property, the period beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or is ready to be held for sale. See *also* section 1.263A-12.

Section 1.263A-8(a)(1) provides that capitalization of interest under the avoided cost method described in section 1.263A-9 is required with respect to the production of designated property described in section 1.263A-8(b).

Section 1.263A-8(a)(2) provides that interest that is capitalized under section 1.263A-8 is treated as a cost of the designated property and is recovered in accordance with section 1.263A-1(c)(4).

The term "designated property" is defined in section 1.263A-8(b)(1) as meaning, in general, any property that is produced and that is either (i) real property (as defined in section 1.263A-8(c)); or (ii) tangible personal property (as defined in section 1.263A-2(a)(2)) that meets any of the following criteria: (A) property with a class life of 20 years or more under section 168 but only if the property is not property described in section 1221(1) in the hands of the taxpayer or a related person; (B) property with an estimated production period (as defined in section 1.263A-12) exceeding 2 years; or (C) property

with an estimated production period exceeding 1 year and an estimated cost of production exceeding \$1,000,000.

Section 446(e) and section 1.446-1(e)(2)(i) provide that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner of Internal Revenue before changing a method of accounting for federal income tax purposes.

Section 1.446-1(e)(2)(ii)(a) provides that a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.

Section 1.446-1(e)(2)(ii)(a) further provides that although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed federal income tax returns represents consistent treatment of that item for purposes of section 1.446-1(e)(2)(ii)(a). However, if a taxpayer treats an item properly in the first return that reflects the item, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive returns to have adopted a method of accounting. See Rev. Rul. 90-38, 1990-1 C.B. 57.

Section 1.446-1(e)(2)(ii)(b) provides that a change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. A change in method of accounting also does not include a change in treatment resulting from a change in underlying facts.

Section 1.446-1(e)(2)(ii)(d)(2)(ii) provides, in part, that a change from not claiming to claiming the additional first year depreciation deduction provided by section 168(k) and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property) is a change in method of accounting, provided the taxpayer did not make the election out of the additional first year depreciation deduction for the class of property in which the depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property) is included.

Section 1.446-1(e)(2)(ii)(d)(3)(iii) provides, in part, that the making of a late depreciation election is not a change in method of accounting, except as otherwise provided by the Code, the Income Tax Regulations, or other guidance published in the Internal Revenue Bulletin.

Rev. Proc. 2011-14 is the exclusive procedure for any taxpayer within its scope to obtain automatic consent to change the methods of accounting specified in the Appendix of Rev. Proc. 2011-14. See section 4.01 of Rev. Proc. 2011-14.

Section 6.01 of the Appendix of Rev. Proc. 2011-14 refers specifically to a change in method of accounting for depreciation for certain taxpayers and certain depreciable property. Section 6.01(1)(a) of the Appendix of Rev. Proc. 2011-14 provides that this section 6.01 of the Appendix applies to a taxpayer that wants to change from an impermissible to a permissible method of accounting for depreciation or amortization (depreciation) for any item of depreciable or amortizable property: (i) for which the taxpayer used the impermissible method of accounting in at least two taxable years immediately preceding the year of change (but see section 6.01(1)(b) of the Appendix of Rev. Proc. 2011-14 for property placed in service in the taxable year immediately preceding the year of change); (ii) for which the taxpayer is making a change in method of accounting under section 1.446-1(e)(2)(ii)(d); (iii) for which depreciation is determined under, in relevant part, section 168 or under any additional first year depreciation deduction provision of the Code (for example, section 168(k)); and (iv) that is owned by the taxpayer at the beginning of the year of change.

Section 6.01(1)(b) of the Appendix of Rev. Proc. 2011-14 provides that if a taxpayer does not satisfy section 6.01(1)(a)(i) of the Appendix of Rev. Proc. 2011-14 for an item of depreciable or amortizable property because this item of property is placed in service by the taxpayer in the taxable year immediately preceding the year of change ("1-year depreciable property"), the taxpayer may change from the impermissible method of determining depreciation to the permissible method of determining depreciation for the 1-year depreciable property by filing a Form 3115 for this change, provided the section 481(a) adjustment reported on the Form 3115 includes the amount of any adjustment that is attributable to all property (including the 1-year depreciable property) subject to the Form 3115. Alternatively, the taxpayer may change from the impermissible method of determining depreciation to the permissible method of determining depreciation for the 1-year depreciable property by filing an amended federal tax return for the property's placed-in-service year prior to the date the taxpayer files its federal tax return for the taxable year succeeding the placed-in-service year.

Ruling Requests 1, 2, 3, and 4

For purposes of applying the 50-percent additional first year depreciation deduction, the determination of whether property is self-constructed property is made under section 1.168(k)-1(b)(4)(iii)(A).

In this case, the Facility was constructed for Taxpayer by E under the Contract that Taxpayer represents was entered into before construction of the Facility. The Contract is dated Date1, which is prior to January , 20 . Taxpayer represents that the Contract is a binding contract under the law of State1. Taxpayer also represents that the Contract does not limit damages to an amount that is less than percent of the Contract price.

However, the Contract was subject to a number of amendments and one change order. One of the amendments reduced the guaranteed output of the Facility by percent and raised the guaranteed heat rate for the Facility by percent. Neither the amendments nor the change order to the Contract changed the location of the Facility or the nominal nameplate capacity of the Facility. The Contract also was subject to an arbitration proceeding and the Settlement Agreement in Year3, which is after 20 . The payments made as a result of the arbitration proceedings, the Settlement Agreement, and the amendments and change order to the Contract increased the total cost of the Facility by approximately percent. Section 1.168(k)-1(b)(4)(ii)(B) provides, in part, that a contract will continue to be binding if the parties make insubstantial changes in its terms and conditions. We find the approximately - percent increase in the total cost of the Facility, the -percent decrease in the guaranteed output of the Facility, and 0.6-percent increase in the guaranteed heat rate of the Facility, and the revised milestones to be insubstantial changes to the terms and conditions of the Contract. Accordingly, the Contract dated Date1, continues to be binding for purposes of section 1.168(k)-1(b)(4).

Consequently, the Facility is self-constructed property for purposes of the 50-percent additional first year depreciation deduction provided by section 168(k)(1). Because the Facility is self-constructed property, it is acquired by Taxpayer when Taxpayer begins construction of the Facility for purposes of the acquisition requirement of section 168(k)(2)(A)(iii), section 168(k)(2)(E)(i), and section 1.168(k)-1(b)(4)(i).

For self-constructed property, the acquisition requirement for purposes of the 50-percent additional first year depreciation deduction is treated as met if Taxpayer begins manufacturing, constructing, or producing the property after December 31, 2007, and before January 1, 2013 (before January 1, 2014, in the case of qualified property described in section 168(k)(2)(B) or (C)).

For purposes of the 50-percent additional first year depreciation deduction, manufacture, construction, or production of property begins when physical work of a significant nature begins. To make this determination, the taxpayer may choose to apply the 10-percent safe harbor rule under section 1.168(k)-1(b)(4)(iii)(B)(2).

Under this safe harbor, physical work of a significant nature will not be considered to begin before an accrual basis taxpayer incurs more than 10 percent of the

total cost of the property (excluding the cost of any land and preliminary activities). Because the term "incurred" is neither defined nor given any special meaning in section 168(k) or its underlying regulations or legislative history, the determination of when an accrual basis taxpayer has incurred more than 10 percent of the total cost of the property is made using the all events test and economic performance requirement of section 461, which specifically governs the timing of the deductions, costs, and expenses at issue.

If Taxpayer chooses the safe harbor rule of section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility, such rule applies for determining when Taxpayer began construction of the Facility. Under this safe harbor rule, Taxpayer, an accrual basis taxpayer, determines when it incurred more than 10 percent of the total cost of the Facility by applying the all events test and economic performance requirement of section 461.

In this case, Taxpayer represents that the Contract is a turnkey contract under which the care, custody, and risk of loss for the Facility passes to Taxpayer upon Substantial Completion and Taxpayer assumes operational control of the Facility upon Substantial Completion. Costs associated with the provision of property are incurred when all the events have occurred that establish the fact of liability, the amount of the liability can be determined with reasonable accuracy, and the property has been provided to Taxpayer. In this case, Taxpayer represents that its method of accounting for purposes of section 1.461-4(d)(6)(iii) is to treat property as provided to Taxpayer when the property is accepted by Taxpayer. Based on the facts represented, the all events test is satisfied and economic performance has occurred when Substantial Completion, as provided for by the Contract, occurs. At that time, the liability is fixed, the amount of the liability has been determined with reasonable accuracy, and the risk of loss has passed to Taxpayer.

Taxpayer represents that Substantial Completion, as defined under the Contract, of the Facility occurred on Date6. Thus, no costs attributable to the Contract were incurred by Taxpayer before Date6.

Ruling Request 5

However, in addition to the costs attributable to the Contract, Taxpayer incurred other costs for the Facility for items such as permitting, project development, project design, engineering, preconstruction, and construction management. Further, in accordance with section 263A(f)(1) and section 1.263A-8(a), Taxpayer capitalized interest during the production periods of the Facility. Pursuant to section 1.263A-8(a)(2), the interest that Taxpayer capitalized under section 1.263A-8 to the Facility is treated as a cost of the Facility.

For purposes of the safe harbor rule under section 1.168(k)-1(b)(4)(iii)(B)(2), the total cost of the property excludes the cost of any land and preliminary activities such as

planning or designing, securing financing, exploring, or researching. We do not consider interest capitalized under section 263A(f) to be a preliminary activity. Accordingly, for purposes of the safe harbor rule under section 1.168(k)-1(b)(4)(iii)(B)(2), the total cost of the property includes any interest capitalized under section 263A(f) to that property. In the case of interest, section 1.461-4(e) provides that economic performance occurs as the interest cost economically accrues, in accordance with the principles of relevant provisions of the Code.

Taxpayer represents that assuming that no costs attributable to the Contract were incurred by Taxpayer until Substantial Completion (the subject of ruling request 4), the costs (including capitalized interest) that were incurred as of January 1, 2008, were 10 percent or less of the total cost of the Facility (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching).

Therefore, if Taxpayer chooses the safe harbor rule of section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility, Taxpayer began construction of the Facility after December 31, 2007.

Ruling Request 6

To qualify for the 50-percent additional first year depreciation under section 168(k)(1), property must be "qualified property" under section 168(k)(2). Under section 168(k)(2)(A), qualified property is, in general, property (i) among other things, to which section 168 applies with a recovery period of 20 years or less, (ii) the original use of which commences with the taxpayer after December 31, 2007, (iii) that is acquired by the taxpayer after December 31, 2007, and before January 1, 2013, but only if no written binding contract for the acquisition was in effect before January 1, 2008, or that is acquired by the taxpayer pursuant to a written binding contract which was entered into after December 31, 2007, and before January 1, 2013, and (iv) that is placed in service by the taxpayer before January 1, 2013, or in the case of property described in section 168(k)(2)(B) or (C), before January 1, 2014.

In the case of self-constructed property, section 168(k)(2)(E)(i) (as amended by the TRUIRJCA) provides that the requirements of section 168(k)(2)(A)(iii) shall be treated as met if the taxpayer begins manufacturing, constructing, or producing the property after December 31, 2007, and before January 1, 2013.

However, property is not qualified property if the property is required to be depreciated under the ADS pursuant to section 168(g)(1)(A) through (D) or other provisions of the Code. Section 168(k)(2)(D)(i) and section 1.168(k)-1(b)(2)(ii)(A)(2).

Taxpayer represents that the Facility is included in either asset class 49.13 or asset class 49.14 of Rev. Proc. 87-56. Property included in asset class 49.13 or asset

class 49.14 is 20-year property. Thus, for purposes of section 168(k)(2)(A)(i), the recovery period of the Facility is 20 years. Further, section 168 applies to the Facility. Moreover, Taxpayer represents that the property subject to this letter ruling request with respect to the Facility is not required to be depreciated under the ADS.

Taxpayer represents that the original use of the Facility commenced with Taxpayer and the Facility was originally placed in service on Date6, which is after December 31, 2007, and before September 9, 2010. Thus, the original use of the Facility commenced with Taxpayer after December 31, 2007, and Taxpayer placed in service the Facility after December 31, 2007, and before September 9, 2010.

Further, as previously discussed, the Facility is self-constructed property and, if Taxpayer chooses the safe harbor rule of section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility, construction of the Facility began after December 31, 2007. Consequently, if Taxpayer chooses the safe harbor rule of section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility, the Facility satisfies the requirements of section 168(k)(2)(E)(i) and, therefore, the acquisition requirement in section 168(k)(2)(A)(iii) is treated as met.

Therefore, if Taxpayer chooses the safe harbor rule of section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility, the section 1245 property of the Facility meets all of the requirements to be qualified property under section 168(k)(2)(A) and is eligible for the 50-percent additional first year depreciation deduction under section 168(k)(1) (assuming section 168(k)(2)(D)(ii) and (iii), section 168(k)(2)(E)(ii)-(iv), and section 168(k)(4) do not apply).

Ruling Request 7

As concluded under ruling request 6, the section 1245 property of the Facility meets all of the requirements to be qualified property under section 168(k)(2)(A) and is eligible for the 50-percent additional first year depreciation deduction under section 168(k)(1) if Taxpayer chooses the safe harbor rule of section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility (and also assuming section 168(k)(2)(D)(ii) and (iii), section 168(k)(2)(E)(ii)-(iv), and section 168(k)(4) do not apply).

Taxpayer represents that it did not claim the additional first year depreciation under section 168(k) for the Facility for the Year2 taxable year. Taxpayer further represents that it did not make an election not to deduct the additional first year depreciation under section 168(k) for any class of qualified property placed in service by Taxpayer during Year2.

The issue under ruling request 7 is whether or not Taxpayer may choose to apply the safe harbor rule provided in section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility by filing a request under section 446(e) to change the taxpayer's method of accounting (*i.e.*, by filing a Form 3115).

Section 1.168(k)-1(b)(4)(iii)(B)(2) provides that a taxpayer chooses to apply the safe harbor rule provided in section 1.168(k)-1(b)(4)(iii)(B)(2) by filing an income tax return for the placed-in-service year of the property that determines when physical work of a significant nature begins consistent with section 1.168(k)-1(b)(4)(iii)(B)(2). We do not consider the choice to apply this safe harbor rule to be an election for purposes of section 1.446-1(e)(2)(ii)(d)(3)(iii).

Section 1.446-1(e)(2)(ii)(d)(2)(ii) provides, in part, that a change from not claiming to claiming the additional first year depreciation deduction provided by section 168(k) and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property) is a change in method of accounting, provided the taxpayer did not make the election out of the additional first year depreciation deduction for the class of property in which the depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property) is included.

Section 6.01 of the Appendix of Rev. Proc. 2011-14 generally applies to a taxpayer that wants to change from not claiming to claiming the additional first year depreciation deduction provided by section 168(k) for qualified property. The Facility is 1-year depreciable property as defined in section 6.01(1)(b) of the Appendix of Rev. Proc. 2011-14. As a result, section 6.01(1)(b) of the Appendix of Rev. Proc. 2011-14 allows Taxpayer to change from not claiming to claiming the 50-percent additional first year depreciation deduction provided by section 168(k)(1) for the section 1245 property that is located at the Facility and placed in service in Year2 by filing a Form 3115 for this change, provided the section 481(a) adjustment reported on the Form 3115 includes the amount of any adjustment that is attributable to all property (including the 1-year depreciable property) subject to the Form 3115.

As a result of the 1-year depreciable property rule in section 6.01(1)(b) of the Appendix of Rev. Proc. 2011-14, the fact that Taxpayer did not claim any additional first year depreciation deduction for the Facility in Year2, and the fact that Taxpayer did not make an election not to deduct the additional first year depreciation under section 168(k) for any class of qualified property placed in service by Taxpayer during Year2, Taxpayer may choose to apply the safe harbor rule provided in section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility by filing a request under section 446(e) to change the taxpayer's method of accounting (*i.e.*, by filing a Form 3115). Accordingly, Taxpayer may change from not claiming to claiming the 50-percent additional first year depreciation deduction provided by section 168(k)(1) for the section 1245 property that is located at the Facility and placed in service in Year2 by filing a Form 3115 for the Year3 taxable year under section 6.01 of the Appendix of Rev. Proc. 2011-14, provided the section 481(a) adjustment reported on the Form 3115 includes the amount of any

adjustment that is attributable to all property (including the section 1245 property that is located at the Facility and placed in service in Year2) subject to the Form 3115.

CONCLUSIONS

Based solely on Taxpayer's representations and the relevant law and analysis set forth above, we conclude that:

1. The Contract is a written binding contract within the meaning of section 1.168(k)-1(b)(4)(ii).
2. The Facility is self-constructed property as defined in section 1.168(k)-1(b)(4)(iii)(A).
3. The fact that Taxpayer and E entered into the Contract prior to January 1, 2008, does not prevent the Facility from meeting the acquisition requirements in section 168(k)(2)(A)(iii).
4. For purposes of determining when physical work of a significant nature begins under the safe harbor under section 1.168(k)-1(b)(4)(iii)(B)(2), no costs are incurred by Taxpayer under the Contract until Substantial Completion (as defined in the Contract) has occurred. As a result, no costs attributable to the Contract were incurred until Date6.
5. For purposes of section 1.168(k)-1(b)(4)(iii)(B)(2), construction of the Facility began after December 31, 2007 (if Taxpayer chooses the 10-percent safe harbor rule under section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility).
6. The section 1245 property at the Facility qualifies for the 50-percent additional first year depreciation deduction under section 168(k)(1) (if Taxpayer chooses the 10-percent safe harbor rule under section 1.168(k)-1(b)(4)(iii)(B)(2) for the Facility) (and also assuming section 168(k)(2)(D)(ii) and (iii), section 168(k)(2)(E)(ii)-(iv), and section 168(k)(4) do not apply).
7. Taxpayer may change from not claiming to claiming the additional first year depreciation deduction provided by section 168(k) for the section 1245 property of the Facility by filing a request for an automatic change in its method of accounting for the Year3 taxable year (assuming none of the scope limitations under section 4.02 of Rev. Proc. 2011-14 apply, assuming Taxpayer obtains the consent of the director as provided in section 6.03(4) of Rev. Proc. 2011-14, and assuming Taxpayer, the Facility, or the requested change in method of accounting is not described in section 6.01(1)(c) of the Appendix of Rev. Proc. 2011-14).

Except as specifically set forth above, no opinion is expressed or implied concerning the tax consequences of the facts described above under any other provisions of the Code (including other subsections of section 168). Specifically, no opinion is expressed or implied on: (i) whether the Contract is a binding contract under the law of State1 or any other State; (ii) the original-use date and the placed-in-service date of the Facility; (iii) the asset classification under Rev. Proc. 87-56 of the section 1245 property located at the Facility; or (iv) whether Taxpayer's method of capitalizing interest is in accordance with section 263A(f) and the regulations thereunder. Taxpayer's interest capitalization method of accounting includes, but is not limited to, when production starts and ends, what expenses are included in accumulated production expenditures, measurement periods, etc.

In accordance with the power of attorney, we are sending a copy of this letter to Taxpayer's authorized representatives. We are also sending a copy of this letter to the appropriate operating division director.

This letter ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Kathleen Reed

Kathleen Reed
Chief, Branch 7
Office of Associate Chief Counsel
(Income Tax and Accounting)

Enclosures (2):

copy of this letter

copy for section 6110 purposes